In the past decades the internet has become a very active distribution channel, bringing benefits to consumers as well as new business opportunities for firms.

Suppliers had to adjust their distribution systems to account for this change in the retail environment, as they did before for many other retail-sector upheavals - e.g. shopping malls, mail orders, supermarket chains or discount stores. Adjustments that already occurred and adjustments which are likely to occur give rise to new concerns on the much debated antitrust issue of Vertical Restraints (VRs).

Vertical Restraints are commonly defined as agreements between two parties at different levels of the supply chain (typically, between manufacturers and distributors). These agreements might be driven by efficiency motives, but could also lead to anti-competitive effects.

The European Approach

In the EU, the European Commission has built a series of relative presumptions on VRs, both of legality and of illegality. The general presumption is that, absent a significant market power either upstream or downstream, VRs are likely to be pro-competitive as they serve efficiency purposes. As market power is difficult to measure, it is usually proxied by the market share of the parties. This is the rationale underpinning the Block Exemption Regulation (BER) and accompanying Guidelines of the European Commission, according to which if each of the parties has a market share below 30%, a VR is, generally, supposed to satisfy the conditions set out in Article 101(3) TFEU and therefore to be legal.

There are, nevertheless, some exceptions to the general rule. Some practices are qualified as hard-core restrictions. For them the general presumption is reversed: even if none of the parties seem to enjoy market power, the agreement is presumed to fall within the scope of Article 101(1) TFEU and to fail to meet the conditions of Article 101(3). Under these circumstances, the VR is allegedly illegal, but the parties have the possibility to plea for a legal exemption in individual cases.
It must be noted that most of the limitations of on-line sales that might be included in distribution agreements are regarded as hard-core restrictions of active and passive sales, therefore not covered by the BER.

From an economic perspective, this approach might carry some risks to the extent that it could overlook manufacturer’s strategic decisions. In a nutshell, a manufacturer when deciding how to tackle inefficiencies arising from the vertical relationship with distributors, is faced with many options, entailing different costs and benefits. Thus, there could be efficiency motives driving the imposition of a limit (or an outright ban) on on-line sales. For instance, internet sales could be constrained in order to preserve the quality or the image of a product. However, in the EU the conditions to be met in order to benefit from an exemption are extremely tight, therefore in many cases the manufacturer would be prevented from introducing the limitation in the first place, even though this could generate efficiencies, benefiting consumers as well as manufacturers.

One could argue that this approach is practically restricting the manufacturer’s choice, who is likely to adopt less efficient strategies, which may in turn raise wholesale prices, and ultimately hurt consumer welfare by driving retail prices up or lowering quality.

**Selective distribution systems**

Producers of luxury, experience and credence goods are among the ones which feared the most the internet as a distribution channel, because they typically adopt selective distribution systems in order to preserve the brand equity of their products.

On-line sales present some characteristics that may conflict with the objectives of selective distribution. Indeed, e-commerce tends to increase price competition and poses some problems of asymmetry of information that may exacerbate the difficulties that selective distribution is meant to overcome. Hence, for some products the internet may be an inadequate marketplace and this, in principle, explains why a supplier may want to completely prevent on-line sales.

The risk of foreclosure of certain type(s) of distributors could endanger competition especially in case of cumulative effects of parallel selective distribution networks adopted by more players in the same market.

As already pointed out, the European attitude toward this restraint is firmly negative. An outright ban of on-line sales within a selective distribution system is considered a hard-core restriction which amounts to an infringement by object of Article 101(1), unless it is justified by “objective reasons”. This approach might be too strict. Indeed, one may wonder in what respects a decision to sell some products (e.g. toothpaste) only in one distribution channel (e.g. pharmacies) precluding their sales in other channels (e.g. supermarkets) is really different from the decision to prevent the sales of the same products over the internet. Since a distribution system that excludes supermarkets is not in general presumed to unduly restrict competition, it is not clear why such a general presumption is valid when the excluded distribution channel is the electronic one.

Recently, the news reported many cases in Europe involving vertical agreements that presented limitations on internet sales. One of the most controversial cases, *Pierre Fabre*, was recently closed. In what follows we will provide a brief overview of the case and then we will seek to sketch a different approach in the assessment of the restraints and see whether this could lead to a different and better outcome.

**A Recent Case: Pierre Fabre**

*Pierre Fabre Dermo-Cosmétique* (Pierre Fabre) is a cosmetic and personal care product manufacturer. Pierre Fabre markets his products through a selective distribution network. Distributors are selected on the basis of the quality of the point of sale and the requirement of a qualified pharmacist to assist the sales.
In 2008, the Conseil de la Concurrence[^4] held that Pierre Fabre’s distribution agreements were anticompetitive under French and EU competition law and did not fall within the scope of the Block Exemption nor could benefit from an individual exemption. Therefore, it ordered to amend the contracts as to enable retailers to sell products on-line. Pierre Fabre claimed that banning on-line sales was justified by health protection purposes (i.e. dermatological risk of using the products without appropriate pharmacist advice) and by the need to prevent counterfeits. However, in its decision the Conseil rejected those justifications as immaterial, because parapharmaceutical products were not medicines, and selecting specialist distributors was sufficient to guarantee the product quality.

The manufacturer brought the case before the Cour d’appel de Paris[^6], which in turn referred the underlying point of law to the ECJ for interpretation. The ECJ ruled[^7] that the restraint imposed by Pierre Fabre, being a de facto ban on the use of the internet as a channel of sale, amounted to a restriction by object, within the meaning of Article 101(1), not objectively justified. The BER, therefore, did not apply, while it was for the company to demonstrate that such restraints were individually exempted within the meaning of Article 101(3).

On January 2013 the Cour d’appel de Paris[^8] rejected the appeal[^9]. In its judgement, the Cour confirmed that a de facto prohibition of on-line sales of cosmetics is to be regarded as an infringement “by object” of Article 101(1). It opined that preventing consumers from buying on the internet would limit their ability to shop in more distant geographic areas and to compare prices and, therefore, would result in a reduction of intra-brand competition. The Cour also rejected the request for an individual exemption, as it argued that Pierre Fabre had failed to meet the standards required to prove the existence of the claimed efficiency gains and that, moreover, a complete ban of on-line sales was not indispensable to achieve these efficiencies.

The Pierre Fabre case is a clear account of the difficulties that a producer might encounter in seeking to provide justifications that fulfil the conditions to benefit from an exemption provided for in Article 101(3).

In the past few years, the Commission has made significant effort in order to move away from the long criticised form-based approach to land in the realm of more widely recognised assessment methods based on economic analysis, also referred to as effect-based approach.

Pierre Fabre judgement, and most of the other similar cases in Europe[^7], however, seem to work against the claimed objectives. In particular, some thorny questions remain to be addressed. Is there a tendency to establish a presumption of illegality on all restraints concerning internet sales? Is this to be intended as a way to speed up decisions and judgements? Is this approach constraining firms’ ability to set their distribution strategies?

We will now present some stylised economic arguments, on which our subsequent analysis will be based. Before moving to that, it is worth mentioning one interesting insight: none of the decision-makers involved in the Pierre Fabre case (the Conseil, the Court of Justice, the Cour d’appel de Paris) seems to have considered the following questions: why did Pierre Fabre seek to prevent on-line sales? In which way this distribution strategy would have increased his profits?

**Economic rationale of VRs**

There is a whole strand of Industrial Organisation literature focusing on the economics of Vertical Restraints. The insights produced by economic theory on VRs are valid for the digital marketplace, as the competitive forces active in the market are unvaried.

The objective of any rational manufacturer is that of increasing his profits, and, assuming vertical integration is not the optimal solution, he seeks to do so, _ceteris paribus[^8]_, through his relationship with retailers by maximising consumer demand, the larger the better.
Demand is a function of the price charged by retailers to consumers and perceived quality of the product:

\[ d = f(p, s) \]

In other words, demand for the manufacturer’s product \( (d) \) is negatively related to the retail price \( p \) (the price set by retailers) and positively affected by \( s \) which here stands for the intangible features of the product, such as brand image, depending on retailers’ conducts and other additional efforts, exerted at retail level that ensure the provision of ancillary services, both pre and after sales.

From this simple equation we can easily see that an increase in retail price \( (p) \) would push quantity demanded \( (d) \) down and negatively affect the manufacturer’s profit. Indeed, a manufacturer has the incentive to mitigate the retailers’ ability to charge prices above the competitive level in order to increase the quantity sold and ultimately gain from increased quantity demanded by retailers. Similarly, the manufacturer prefers high levels of \( s \), which generate vertical and horizontal positive externalities, enhancing demand for the manufacturer’s product and therefore increasing his profits.

This shows that consumer interests are aligned to manufacturer’s interests, as they similarly prefer low retail prices \( (p) \) and high levels of services \( (s) \). For this reason, economic theory suggests that when a manufacturer decides to unilaterally and voluntarily impose a constraint on its distributors, this is likely to benefit consumers.

A manufacturer may also allow some market power at retail level if this induces retailers to exert some additional effort (for instance, improved pre-sale services to customers or better display of the producer’s products), which will positively affect the overall demanded quantity. In so doing, the manufacturer seeks to capitalise on the positive externality produced by the additional services in the downstream market.

The welfare considerations linked to this practice are still ambiguous. While the VR would primarily affect intra-brand competition, its welfare consequences depend on the degree of existing inter-brand competition, and on how this type of competition is influenced by the VR. If inter-brand competition is fierce and remains so also when the VR is in place, than the VR is unlikely to reduce welfare, even if it softens intra-brand competition.

Indeed, in some cases consumers too may be willing to pay higher prices when these are linked to better advices and improved purchasing experiences.

From the reasoning presented above, it is apparent that in the assessment of the welfare effect of a VR, it is crucial to consider whether such a restraint will only affect intra-brand competition or both intra- and inter-brand competition. How to understand which type(s) of competition will be impacted? In many cases, some clear indicators can be found carrying out an enquiry on the motivations driving such a decision on the manufacturer’s side. Why did he adopt the VR under exam? Is it credible that his motive was that of altering inter-brand competition?

Through which channels?

**Revisiting Pierre Fabre. A (True) Economic Perspective**

In the light of the approach presented above, would Pierre Fabre judgement be different, had the courts adopted a different attitude?

It might be interesting to see what would have happened if the authority and the courts had embraced a more economic approach which is indeed more in line with the vented goal of competition policy: preserving competition to the benefit of consumers.

Resuming the simple model presented above, and assuming that Pierre Fabre is a profit-maximising producer, it could be contended that Pierre Fabre strives to restrict on-line sales for one of the following reason: either to reduce the retail price \( (p) \) or to increase or preserve the level of services \( (s) \).
The first option (to reduce $p$) seems unlikely. Pierre Fabre vertical agreements, which preclude on-line sales, are likely to reduce intra-brand competition, protecting retailers from a very strong source of price competition – i.e. the internet. Therefore, this constraint will drive retail prices up, rather than down, to the detriment of the manufacturer’s profit.

The second option (to increase $s$), instead, should be considered together with the nature of the products and the relevance of the complementary services for the marketing strategy. In particular, the manufacturer may seek to preserve the perceived product and service quality not allowing sales through the internet. This strategy might also be intended to induce pre-sale services at retail level, that exert positive vertical and horizontal externalities, boosting demand. For instance, requiring the presence of a pharmacist to advice clients not only enhances the brand image but also minimises the risk of customer being unhappy with the product purchased.

A different competitive problem concerns the risk that a selective distribution system may foreclose certain types of distributors, and Pierre Fabre’s agreements do discriminate against pure on-line retailers, as they are de facto not allowed to join the distribution network. However, some evidence available evidence show that this competitive risk is very unlikely.

First of all, the Cour d’appel de Paris confirmed, in its recent judgement, that Pierre Fabre holds 20% share of the French market for cosmetics and personal care to be sold with the advice of a pharmacist. Despite such a narrow definition of the market, Pierre Fabre position is far from being dominant. Its closest competitor is Cosmétique Active France (a L’Oreal subsidiary) that holds more than 18% market share, and the second closest rival is above 10%. Pierre Fabre’s major competitors adopt a selective distribution system, although most of them allow their distributors to use the internet as a sale channel. Such a setting suggests that inter-brand competition is active in the market and a voluntarily imposed restriction on internet sales by one of the players is not likely to affect inter-brand competition. Similarly, collusion is improbable since Pierre Fabre is the only producer in the market imposing this restraint, so no cumulative effects of parallel selective distribution networks occur.

Perhaps the most important lesson that can be learnt from the above discussion is that regardless of whether vertical restraints in the digital world, as in the offline one, are driven by efficiency motives or anticompetitive reasons, carrying out a thorough economic analysis may shed some light on relevant aspects that would otherwise be ignored.

Conclusions

This note sketched a stylised framework of assessment of VRs, and sought to analyse some critical issues that are often neglected. The current European approach is likely to limit significantly the producers’ distribution choice, and in some cases they will be prevented from addressing inefficiencies through optimal vertical agreements.

Should the presumption be reversed, transferring on the authority the burden of proving an agreement to be anticompetitive? Would this generate fewer errors, and enhance consumer welfare? We believe so.

If you would like further information about vertical restraints and the economic assessment of their competitive effects, please contact us.

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Notes

1 VRs may be introduced in order to improve the vertical structure by reducing transaction costs, improving the stability of supplies, and as a device to align the two firms’ interests. Whereas, the usual competitive risks are related to the softening of competition, that may follow the introduction of some restraints.


3 For instance, the followings are considered hard-core restrictions: restriction on resale price (e.g. Resale Price Maintenance, excluding maximum resale price and recommended resale price) or restriction of passive sales.

4 Conseil de la concurrence, 29 October 2008, Decision n° 08-D-25, regarding practices in the sector of distribution or personal care and cosmetic products sold upon pharmaceutical advice, Pierre Fabre Dermo-Cosmétique.


6 Cour d’appel de Paris, 31 January 2013, RG n° 2008/23812, Pierre Fabre Dermo-Cosmétique


8 Given $p = f(w, m)$, where $w$ is the wholesale price paid by the retailer to the manufacturer and $m$ the mark-up charged by the retailer, we are assuming manufacturer and retailers costs to be unvaried, as a consequence the final price to consumers ($p$) will only be affected by the ability of the retailer to charge a mark-up. Similarly, the manufacturer’s profit maximisation problem is only concerned with demand, since we maintain wholesale price unchanged.

9 On the retailers’ side, it might be argued that they pursue different objectives. In particular they would maximise their profits by charging higher mark-ups, therefore higher prices to consumers ($p$), and keeping retail services (which are represented by $s$ in our model) low, as these entails costs for the retailer.

10 Our analysis compares the factual scenario against the counterfactual scenario, which in this case is the hypothetical setting where Pierre Fabre allows on-line sales.

11 ‘The Commission considers that low market shares are generally a good proxy for the absence of substantial market power. The Commission's experience suggests that dominance is not likely if the undertaking’s market share is below 40 % in the relevant market. However, there may be specific cases below that threshold where competitors are not in a position to constrain effectively the conduct of a dominant undertaking’ Paragraph 14, Communication from the Commission - Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings [2009] O.J. C 045. It could therefore be contended that 20% market share is unlikely to generate dominance in a market. However, even if we were to assume potential dominance by Pierre Fabre, as suggested by the Guidance excerpt, we would need to assess the competitive environment and according to the appeal judgement inter-brand competition is really active in that market.

12 Pierre Fabre’s major competitors do not limit on-line sales, and are indeed achieving significant sales improvements through e-commerce.